BEFORE THE TENNESSEE STATE BOARD OF EQUALIZATION

IN RE:	Heil Avenue Properties	)
	Map 63E, Group C, Control Map 63L, Parcel 10.00L	) Marshall County
	Industrial Property	)
	Tax Years 2004 & 2005	)

INITIAL DECISION AND ORDER

Statement of the Case

The subject property is presently valued for leasehold purposes as follows:[1]

	TOTAL VALUE	ASSESSMENT
Tax Year 2004	$2,887,700	$1,155,080
Tax Year 2005	$2,914,100	$1,165,640

An appeal has been filed on behalf of the lessee with the State Board of Equalization. The undersigned administrative judge conducted a hearing in this matter on July 31, 2006 in Nashville, Tennessee. The appellant, Heil Avenue Properties, Inc. was represented by L. Marshall Albritton, Esq. The assessor of property, Linda Haislip, and intervenor, Division of Property Assessments, were represented by Robert T. Lee, Esq. Also in attendance at the hearing were Larry McKnight, Anthony Beyer, Jay Catignani and George C. Hoch, TMA.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

I. Background

Subject property consists of a 56.50 acre site improved with five buildings containing a total of 762,582 square feet of manufacturing/warehouse area and 28,290 square feet of office space located at 651 Heil Avenue in Lewisburg, Tennessee. Subject property was constructed in various stages between the 1930's and 1994.

The subject property formerly housed International Comfort Products which was also known as the Carrier plant. Carrier announced in March of 2002 that it would be closing this facility resulting in the loss of approximately 2,000 jobs. At that time, Carrier was the largest employer in Marshall County.

Subject property was placed on the market by Carrier through Colliers Turley Martin Tucker on May 30, 2002. On August 5, 2003, the appellant, Heil Avenue Properties, Inc. ["Heil"], purchased subject property for $1,735,000. On August 11, 2003, Heil conveyed title to subject property to the Industrial Development Board of the City of Lewisburg, Tennessee ["IDB"] for $10 with an option to purchase the property back at any time for $100.

[1] The appraisal for 2004 resulted from a back assessment. The appraisal for 2005 resulted from a ruling by the Marshall County Board of Equalization.

As part of the transaction, Heil leased back subject property. The pertinent terms of the lease were summarized by the parties in a stipulation which provides in relevant part as follows:

* * *

4. The term of the lease is for a period of 10 years beginning in August 2003 and ending in August 2013.

5. The lease agreement provides for the following:

   a. "Base rent" is $1 per year;
   b. "Space Rent" is equal to $0.10 per square foot of building space that Lessee either uses or subleases to a sublessee. The use of the Retained Premises at no rental expense to Lessor shall be considered additional rent by Lessee to Lessor, hereinafter "Retained Premises Rent";
   c. "Retained Premises" is office space and warehouse/manufacturing/educational space which the Lessor retains use over;
   d. The rental value of the "Retained Premises" is $1.00 per square foot for warehouse/manufacturing/educational space and $4.00 per square foot for office space.
   e. Lessee is responsible for maintenance and insurance for the premises;
   f. Lessee may deduct cost of providing lighting and insurance for the "Retained Premises" from the annual payments.

6. The square footage of the "Retained Premises" is

   a. Warehouse/manufacturing/education space = 57,280
   b. Office space = 9,000

7. The gross square footage available for use or sublease is (gross leaseable area):

   a. Warehouse/manufacturing/education space = 705,302
   b. Office space = 19,290

* * *

It was also made clear on page 2 of the lease that the IDB's intent in owning and leasing subject property was to increase employment opportunities. In order to further this goal, the 66,280 square feet of retained premises was utilized in conjunction with the IDB's Tennessee Technological Center.

Unlike the lessees in virtually all appeals involving leasehold assessments, Heil does not utilize subject property for an ongoing business operation. Instead, Heil is a developer that seeks to generate income by subleasing the space it leases from the IDB.

II. Contentions of the Parties

Heil maintained that it should not be subject to a leasehold assessment for tax year 2004 and that for tax year 2005 the leasehold should be appraised at $630,000. In support of this position, the taxpayer relied primarily on the analysis of Jay Catignani, an agent registered with the State Board of Equalization pursuant to Tenn. Code Ann. § 67-5-1514.

The basis for Mr. Catignani's conclusion that a leasehold assessment should not be made for tax year 2004 was summarized on page 4 of his report as follows:

> It is the taxpayer's position that a leasehold assessment did not exist for tax year 2004 since the first sub tenant [sic] did not occupy space in the building until March of 2004, some two months after the assessment date.

With respect to tax year 2005, Mr. Catignani prepared a leasehold interest analysis and concluded that the leasehold had a value of $630,000 for ad valorem tax purposes. Underlying Mr. Catignani's analysis was the following statement also found on page 4 of his report:

> Likewise, throughout this entire appeal it will be the taxpayer's position that since the owner has not used any space for himself the Leasehold Valuation is predicated **only on the amount of space that they sublease**. The owners have no intention to occupy any space. They are developers not users. Furthermore, the IDB and or Lessor are in agreement, since the Lessor and/or IDB has not demanded any rental payments to date from the Lessee for any space other than that amount which is generated thru subleasing. In other words, Lessor and Lessee are in agreement on the terms of the lease. In my opinion, this is why the IDB leased the space for only $.10/sf. It was the City of Lewisburg's intent to protect the lessee due to the inherent risks associated with trying to lease 700,000 sf in a secondary location in a former manufacturing facility.

[Emphasis in original]

In addition to the foregoing, Mr. Catignani stressed that Heil purchased subject property in an arm's-length transaction on August 5, 2003 for $1,735,000. According to Mr. Catignani, if the fee simple value of subject property was $1,735,000, the leasehold value cannot logically exceed that figure since the fee simple value is normally the sum of the leased fee and leasehold values.

The taxpayer also offered into evidence the testimony of Larry McKnight, the former Director of Industrial Recruitment and Community Development for the City of Lewisburg, and Anthony Beyer, a principal in Heil. Both Mr. McKnight and Mr. Beyer testified concerning a number of factors reducing the desirability and value of subject property. According to Messrs. McKnight and Beyer, factors adversely affecting subject property include: (1) being located in a residential area; (2) having to depend on an annually renewable lease for access to the rear of subject property; (3) all electricity initially came from a single source making it cost prohibitive to even turn a light on; (4) the size and "cut-up" layout of the facility; and (5) 12' ceiling heights in many areas.

The assessor of property and Division of Property Assessments asserted that subject leasehold should be valued at $4,663,300 and $4,280,300 for tax years 2004 and 2005 respectively. In support of this position, the parties relied on the testimony and written

analysis of George C. Hoch, TMA, an appraiser with the Division of Property Assessments. Like Mr. Catignani, Mr. Hoch prepared what is commonly referred to as a leasehold interest analysis and valuation.

The primary differences between Mr. Hoch and Mr. Catignani concerned their estimates of market rent, expenses and the appropriate discount/capitalization rate. For ease of reference, the appraiser's differences are summarized immediately below:

	Catignani	Hoch
Market Rent	$1.35	$1.50
Expenses	$336,745	$272,438
Discount/Capitalization Rate	13.44%	11.84%

III. Analysis

The administrative judge finds that the burden of proof is on Heil. See State Board of Equalization Rule 0600-1-.11(1) and *Big Fork Mining Company v. Tennessee Water Quality Control Board*, 620 S.W.2d 515 (Tenn. App. 1981).

The administrative judge finds that in Tennessee real property is normally valued in fee simple for ad valorem tax purposes. However, the primary exception to this general rule involves leasehold assessments required under Tenn. Code Ann. § 67-5-502(d) which provides as follows:

> All mineral interests and all other interests of whatever character, not defined as products of the soil, in real property, including the interest which the lessee may have in and to the improvements erected upon land where the fee, reversion, or remainder therein is exempt to the owner, and which interest or interests is or are owned separately from the general freehold, shall be assessed to the owner thereof, separately from the other interests in such real estate, which other interests shall be assessed to the owner thereof, all of which shall be assessed as real property.

The administrative judge finds that the methodology used in making a leasehold assessment is set forth in Tenn. Code Ann. § 67-5-605 which provides as follows:

> Leasehold interests assessable under § 67-5-502 shall be valued by discounting to present value the excess, if any, of fair market rent over actual and imputed rent for the leased premises, for the projected term of the lease including renewal options. By virtue of the speculative nature of valuation of options to purchase, any option which the lessee may be given to purchase the leased premises shall be deemed to have no value. . . .

In other words, if contract rent is less than economic rent the "bonus" to the lessee must be valued by calculating the present worth of the bonus for the remaining term of the lease.

Based upon the foregoing, the administrative judge finds that in order to properly value a leasehold interest the appraiser must first determine both market and contract rent for the subject property. In the present appeal, the administrative judge finds that contract rent is

$1.00 per year plus 10¢ per square foot of building space that Heil either uses or subleases. Thus, the threshold issue before the appraiser concerns whether market rent for subject property equals, exceeds or is less than $1.00 per year plus 10¢ per square foot of building space Heil uses or subleases.

A. Tax Year 2004

The administrative judge finds Mr. Catignani concluded that no leasehold value existed on January 1, 2004 because none of the space was subleased as of that date. Respectfully, the administrative judge finds that the relevant inquiry does not concern the amount of square footage successfully subleased on January 1, 2004. The administrative judge finds that the relevant inquiry pertains to whether Heil's contractual rental rate of $1.00 per year plus 10¢ per square foot of space used or subleased constitutes market rent.[2] The administrative judge finds Mr. Catignani simply failed to address this issue and his analysis must therefore be rejected.

B. Tax Year 2005

As previously stated, Heil has the burden of proof in this matter. Respectfully, the administrative judge finds that Mr. Catignani's analysis lacks sufficient reliability to be adopted as the basis of valuation for several reasons. Initially, the administrative judge finds without merit Mr. Catignani's assumption that the amount of space subleased by Heil constitutes the relevant inquiry. Once again, the administrative judge finds that the threshold issue concerns whether the contract rent paid by Heil represents market rent.

The administrative judge finds Mr. Catignani's reliance on the Appraisal Institute misplaced in this particular case. On page 5 of his report, Mr. Catignani includes the following quote from the 12th edition of The Appraisal of Real Estate:[3]

> A lease never increases the market value of real property rights to the fee simple estate. Any potential value increment in excess of fee simple estate is attributable to the particular lease contract, and even though the rights may legally "run with the land", they constitute contract rather than real property rights.

The administrative judge finds the fact that generally accepted appraisal practices are not always consistent with the requirements of Tennessee law most strikingly illustrated by *National Life and Accident Insurance Co. v. Keaton*, No. 85-326-II, 1986 WL 4846 (Tenn. Ct. App. April 23, 1986) ["National Life"] which was recently reaffirmed in *Spring Hill, L.P. v. Tennessee State Board of Equalization*, No. M2001-02683, 2003 WL 23099679 (Tenn. Ct. App. December 31, 2003) ["Spring Hill"].

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[2] The administrative judge finds that even if the amount of space subleased was relevant, the critical inquiry would concern the present value of the lessee's *anticipated* subleases. In this case, Heil commenced subleasing significant amounts of space on a month-to-month basis beginning in March of 2004.

[3] It is not stated which page the quoted material appears on.

In *National Life*, the Court dealt with the issue of the value of a used computer for Tennessee personal property tax purposes. It was undisputed that an identical computer could be purchased on the open market for $82,000 on the relevant assessment date. The Court stated on page 8 of its opinion that "[s]uch a computer would not have been identical unless it were the subject of a lease providing an identical rental." Accordingly, the Court concluded that the Assessment Appeals Commission properly valued the computer at $875,103 because it was being rented for $31,000 per month on the relevant assessment date.

The administrative judge finds the Court implicitly rejected the notion that what an appraiser would typically consider excess rent should always be disregarded for ad valorem tax purposes. The administrative judge finds that an appraiser valuing the fee simple interest would normally disregard what he or she considered an above-market rental rate.

The administrative judge finds that Mr. Catignani's analysis fails to recognize that the terms "real estate" and "real property" are not synonymous for Tennessee ad valorem tax purposes. For example, in *Spring Hill* the Court ruled it was proper to include the present value of tax credits in valuations of low-income housing properties for Tennessee property tax purposes. The administrative judge finds that *Spring Hill* supports the proposition that although intangibles are not normally assessed per se, to the extent intangibles are inextricably intertwined with the real property, their value-enhancing or value-decreasing effect must be considered when establishing the fair market value of real property for ad valorem tax purposes. See also *Ringier America* (Weakley Co., Tax Year 2003) wherein the administrative judge rejected an argument similar to Mr. Catignani's predicated on the sale of the real estate.

The administrative judge finds that the cross-examination of Mr. Catignani established two fundamental errors in his analysis. First, Mr. Catignani conceded that the $9,854 deduction for the cost to build a wall should not have been included. Second, Mr. Catignani also agreed he should have included as income the $10,200 ground rent payment. The administrative judge finds that these two modifications changed Mr. Catignani's conclusion of value by $100,000 ($630,000) and cast further doubts on the reliability of his analysis as a whole. The administrative judge would also note that the assessor of property and Division of Property Assessments raised several other legitimate concerns about Mr. Catignani's analysis in their post-hearing filing. The administrative judge finds it unnecessary to address those contentions because the foregoing findings require rejection of Mr. Catignani's analysis.

IV. Motion for Directed Verdict

At the conclusion of Heil's proof the assessor and Division of Property Assessments moved for a directed verdict. The administrative judge took the motion under advisement and Mr. Hoch proceeded to testify.

The administrative judge finds that the motion should be granted because Mr. Catignani's analysis is fundamentally flawed for the reasons previously discussed. However, the administrative judge finds that granting the motion simply means that the current appraisals remain in effect based upon a presumption of correctness.

The administrative judge finds that just as a taxpayer must introduce sufficient evidence to support a reduction in value, the government must introduce sufficient evidence to support an increased appraisal. Respectfully, the administrative judge finds that Mr. Hoch's analysis also suffers from serious deficiencies and cannot be adopted as the basis of valuation.

The administrative judge finds that Mr. Hoch's analysis must also be rejected for a number of reasons. First, the administrative judge finds that Mr. Hoch began his analysis by erroneously assuming the parties had stipulated to a market rental rate of $1.50 per square foot. Second, the administrative judge finds Mr. Hoch failed to adequately account for the fact that market rent for subject property is diminished by both environmental problems and the market's inability to absorb so much square footage. Third, the administrative judge finds that Mr. Hoch did not rely on his own professional judgment in substituting a capitalization rate for a discount rate. Mr. Hoch testified that this substitution was based solely on instructions received from a superior.

The administrative judge would also note that Heil criticized Mr. Hoch's analysis for several other reasons which are summarized in its post-hearing brief. Given the foregoing, the administrative judge finds it unnecessary to address those issues. The administrative judge finds that the previously summarized deficiencies in Mr. Hoch's analysis require its rejection.

In summary, the administrative judge must respectfully conclude that the analyses of Messrs. Catignani and Hoch are fundamentally flawed and cannot provide a basis of valuation. Accordingly, the administrative judge finds that the current appraisals of Heil's leasehold interests for tax years 2004 and 2005 should remain in effect based upon presumptions of correctness.

ORDER

It is therefore ORDERED that the following values and assessments be adopted for tax years 2004 and 2005:

	TOTAL VALUE	ASSESSMENT
Tax Year 2004	$2,887,700	$1,155,080
Tax Year 2005	$2,914,100	$1,165,640

It is FURTHER ORDERED that any applicable hearing costs be assessed pursuant to Tenn. Code Ann. § 67-5-1501(d) and State Board of Equalization Rule 0600-1-.17.

Pursuant to the Uniform Administrative Procedures Act, Tenn. Code Ann. §§ 4-5-301—325, Tenn. Code Ann. § 67-5-1501, and the Rules of Contested Case Procedure of the State Board of Equalization, the parties are advised of the following remedies:

1. A party may appeal this decision and order to the Assessment Appeals Commission pursuant to Tenn. Code Ann. § 67-5-1501 and Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization. Tennessee Code Annotated § 67-5-1501(c) provides that an appeal **"must be filed within thirty (30) days from the date the initial decision is sent."** Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization provides that the appeal be filed with the Executive Secretary of the State Board and that the appeal **"identify the allegedly erroneous finding(s) of fact and/or conclusion(s) of law in the initial order"**; or
2. A party may petition for reconsideration of this decision and order pursuant to Tenn. Code Ann. § 4-5-317 within fifteen (15) days of the entry of the order. The petition for reconsideration must state the specific grounds upon which relief is requested. The filing of a petition for reconsideration is not a prerequisite for seeking administrative or judicial review; or
3. A party may petition for a stay of effectiveness of this decision and order pursuant to Tenn. Code Ann. § 4-5-316 within seven (7) days of the entry of the order.

This order does not become final until an official certificate is issued by the Assessment Appeals Commission. Official certificates are normally issued seventy-five (75) days after the entry of the initial decision and order if no party has appealed.

ENTERED this 18th day of August, 2006.

MARK J. MINSKY
ADMINISTRATIVE JUDGE
TENNESSEE DEPARTMENT OF STATE
ADMINISTRATIVE PROCEDURES DIVISION

c: L. Marshall Albritton, Esq.
Robert T. Lee, Esq.
Linda Haislip, Assessor of Property